

SECURITY CHALLENGES ARISING FROM THE
GLOBAL ECONOMIC CRISIS

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Chairman Skelton, Mr. McHugh, it is a distinct privilege for me to appear again before this Committee. Like you, I am deeply concerned that economic crisis that has affected the United States in particular and the international community generally poses a major threat to American national security interests. That threat is likely to manifest itself in four, and possibly five, distinct ways.

First, it will create major pressures on the defense budget, most notably the acquisition – that is, the procurement and research and development accounts.

Second, it will likely result in a further contraction of defense spending, and therefore operations as well and modernization, on the part of key allies and friends.

Third, it could prompt nations that are ambivalent about their relationship with America, most notably China and Russia, to act in ways that are deleterious to American interests.

Fourth, it could prompt even more hostile behavior on the part of nations such as Iran and Venezuela that already bear deep antipathy toward the United States.

Fifth, it could further destabilize states that are already vulnerable to internal unrest.

Finally, it could spur further international criminal behavior that could undermine internal American stability.

Please permit me to address each of these concerns in turn.

The Defense Budget

Economists have long debated whether measuring defense spending as a percentage of the Gross Domestic Product has any real utility. Among those who do see this measure as having either economic or political significance, or both, some have argued that defense spending is too high a percentage of GDP, others have taken the opposite view. Whatever the validity of all of these arguments during so-called “normal” times, during the current economic crisis, in which the GDP is slipping far more sharply than was predicted even two months ago, the issue must be seen in a very different light. Increasing the percent of GDP spent

on defense when GDP is declining may simply mean nothing more than not standing still, or worse, declining with the GDP itself.

The defense budget is already under pressure as a result of the economic crisis. Real growth in defense spending, excluding the wartime supplemental, is but 1.7%. If the supplemental is included the growth in spending is some 1.4%, because next year's supplemental is lower than the planned total of supplemental expenditures in FY 2009. These figures represent a sharp drop in the growth of annual defense spending over the past eight years, which averaged 4.3 per cent. in real terms.

Moreover, the lower rate of defense budget growth will manifest itself most sharply in the acquisition accounts, procurement and research and development. It has been by means of spending funds from these accounts that America has been able to assure itself of long term military superiority, regardless of the capabilities of a potential foe. When these accounts were assaulted, as they were in the late 1970s, not only did our leading adversary, the Soviet Union, become far more reckless, invading Afghanistan, but others, like Iran, also exploited what they perceived to be American weakness and introversion. We were saved from a similar fate in the 1990s because the Soviet Union had collapsed, and because the defense budget recovery of the 1980s enabled us to put powerful forces in the field from Operation Desert Storm onwards. If we do go through another reduction in defense procurement spending, however, can we say with confidence in one or two decades' time no powerful adversary will act upon a perception of American weakness and threaten one of our vital national interests?

It is a truism that, since World War II, virtually every war we have fought was unforeseen. It is equally true that we have consistently structured our future force posture on the basis of a war we had recently fought, or were still fighting. I worry that we are falling into the same trap today; the result could well be, as in Korea, or Iraq, many years of bloodshed and lost treasure until we righted ourselves, or, as in Vietnam, outright failure. The opportunity cost of reductions in planned acquisition budgets are therefore exceedingly high, and, if not reversed, will far outweigh any supposed short-term benefits from budget savings.

Cuts in procurement in particular will have more immediate repercussions as well. They will result in the loss of jobs, in particular, employment for skilled blue collar workers, engineers, and physicists, the very people who earn far less than \$250,000 a year, and at whom the Administration claims it is targeting its recovery plan. Moreover, it is most likely that as jobs dry up, firms will apply the traditional "last-in, first-out" principle. In other words, those who have

benefited from the most up-to-date education and training will be lost to the Nation's vital defense industrial base.

Ironically, even as young American engineers in particular will find themselves unable to contribute to our national security, the United States will continue to train foreign students in the engineering and the hard sciences, thereby enabling them to contribute to military modernization in their own countries. In particular, it is well known that brilliant young Chinese students are populating the top science and engineering programs of our major universities. While American graduates of those programs will find the doors of defense industry closed to them, China's expanding military will welcome Chinese graduates of these programs with open arms.

Members of the committee might also consider that the impact of a flattening of acquisition spending will be unevenly distributed around the country. Those states with major defense industrial activity, including hard hit areas in Michigan, the Northeast and the South, will suffer more than other parts of country. Surely, this cannot be what the Administration intends as it pours hundreds of billions of dollars into job creation programs.

Finally, because the Administration is ratcheting up the national debt so severely, once the economic turnaround does occur, and there is a growing demand for dollars, and a resulting rise in interest rates on government paper, the cost of servicing that debt will rise dramatically. Budget deficits will increase sharply as a result, and the government will be forced to cut back on discretionary programs. Because defense accounts for more than half of the entire US discretionary budget, and has been increasing its percentage of discretionary spending in the past eight years, it will be the most likely target for real cuts, not merely a flattening of the growth rate, in order to "manage" the ballooning deficit. The impact on our national security will be profound, and negative.

Defense Spending as an Economic Stimulus

In her testimony before the House Budget Committee on January 27th, Alice Rivlin, who was Director of the Congressional Budget Office when I was an analyst there, underlined the difference between a short-term stimulus and what she called "a more permanent shift of resources into public investment in future growth." She went on to say that "the first priority is an "anti-recession package that can be both enacted and spent quickly to create and preserve jobs in the near-term, and not add significantly to long run deficits." The defense budget offers several ways to meet her prescription.

Fast spending, job creating programs include:

- o Reducing deferred maintenance, accelerating ship overhauls, and aircraft and ground vehicle rework
- o Advance procurement of subsystems for major units like warships. Such procurement would preserve the second and third tier industrial base, which is most vulnerable to the current downturn
- o Expanding and accelerating military construction and family housing programs.

Of these three elements, only the third is part of the \$787 billion stimulus package that the President signed on February 17th. There is, of course, considerable merit in the \$7.4 billion in defense programs that have been approved, most of which are directed at military construction and operations and maintenance at military facilities; family housing, military hospitals; and the Homeowners' Assistance Program for military families that must sell their homes when undergoing a Permanent Change of Station. But the stimulus does not go far enough in the defense realm, and additional programs to support both rework and overhauls, as well as advance procurement, will create and sustain critical jobs in hard-hit areas.

Alliance Relations

The economic crisis is likely to further diminish the already weak appetite of allies and friends both to increase or even maintain their current levels of defense expenditure, and to contribute to coalition operations in Afghanistan. Few of our major allies and friends spend as much as three per cent. of their Gross Domestic Product on defense. Their GDPs, like ours, are in decline and in several cases, such as Japan, are declining at a far faster rate than ours. Korea and Taiwan, like Japan, are suffering from a drop in exports, notably in the automobile sector. Iceland's financial collapse has received widespread attention.

Economic constraints have at times been an excuse for allies not to do more for the common defense of the West; today, that excuse is being buttressed by reality. Whether excuse or reality, the net result will be exactly the same: the United States will be forced to bear an even heavier burden to defend Western interests, at a time when it will have fewer resources enabling it to do so.

The case of the F-35 provides a distinct example of the interplay between pressures on the US defense budget and alliance relationships. The F-35 program could be one of those affected by the redistribution of defense spending

priorities. There are eight countries that currently are co-developing this aircraft, including key allies Britain, Canada and Australia, and many more planning to purchase it, among them Israel, Singapore and many of the European allies that currently fly F-16s. Any slowdown of the program will increase its costs, and could put it beyond the purchasing power of several F-35 partners. It could also could embitter states that have contributed to its development, furnishing them with yet another reason to be even less inclined to contribute to coalition efforts if Afghanistan, and potentially elsewhere, than they are today.

Ambivalent States

The United States has a complex relationship with two of the world's most powerful states, China and Russia. Neither is an outright adversary, neither is an ally, or even partner, in the sense that describes the relationship of other countries that are not formal American allies. China is particular has significant leverage over the American economy, because of its trade surplus with the United States and its vast holdings of dollars. It has now surpassed Japan as the single largest foreign holder of U.S. Treasury bonds, which totaled nearly \$696.2 billion by the end of 2008.

There has been much recent discussion regarding China's readiness to disrupt the American economy by refusing to accept American Treasury notes or dumping its dollars on the world market. China has done neither, and generally has behaved like a responsible partner as the world financial crisis has deepened, and even as its own GDP is declining from 8-9% to 6 per cent and perhaps even lower. Yet China has taken some major steps to hedge against American economic trends. In particular, it has begun to move its dollar holdings into shorter maturities, giving it more flexibility should it choose to withdraw from the American market.

This flexibility could also enable China to buy into American industry in a major way. That process actually began a few years ago. Indeed, in 2007, well before the financial crisis seriously weakened the American economy, Chinese investments had jumped to \$9.6 billion from the previous year's \$66 million. In 2008 China continued to buy small and larger firms, though some have not played out well, such as the ill-fated stake in Bear Stearns, and underperforming investments in the Blackstone Group and Morgan Stanley. Nevertheless, China is likely to continue to buy American firms, which, when combined with its dollar holdings will give it the kind of economic leverage that it could easily translate into political leverage if it perceives that America's willingness to spend money on its national security is beginning to ebb.

In addition, China's military continues to expand and diversify its capabilities, which are becoming increasingly sophisticated. While China may not match the level of GDP growth it has sustained for nearly two decades, even if its military expands at the same rate as national GDP growth, its modernization program will continue apace.

Russia has not nearly the same economic relationship with the United States as China's, and little economic leverage to speak of. But Russia has become increasingly assertive on the international scene. The cyber bullying of Estonia in May 2007, the August 2008 invasion of Georgia, the naval exercises with Venezuela in the Caribbean in November, and the successful pressure on Kyrgyzstan to close the American airbase at Manas, all point to a Moscow that is determined to recover its former superpower status, and to do so at the expense of the United States and its allies.

Russia cannot yet be called an adversary, and there are many areas where American and Russian interests converge, most notably countering international terrorism and Islamic extremism. Nevertheless, its international behavior is troubling, and even if its oil revenues fail to meet projected levels (Moscow's budgets assumed \$70/barrel, far higher than current prices), it might still choose to continue the military modernization program it recently began.

In particular, Russia appears ready to continue its nuclear modernization, which in absolute terms consumes fewer resources than modernizing its conventional forces. Indeed, only last Thursday deputy defense minister, General Valentin Popovkin explicitly stated that the government would not permit the current financial crisis to slow down its plan to accelerate the modernization of its nuclear forces and its anti-satellite capabilities. He also said that Moscow would procure new missiles to deploy near Poland if the U.S. proceeded with its plans to deploy missile defenses in Poland and the Czech Republic. His statements can hardly be seen as reassuring in the context of a cutback in American military modernization.

Hostile States

The economic crisis, and in particular, the drop in the price of oil, might be expected to limit the military expansion of states unfriendly to America. Yet that need not be the case at all. As appears to be the case with Russia, and as it was with the Soviet Union, a weak economy nevertheless can sustain a military threat to American interests. North Korea's economy has been a basket case for decades; that has not inhibited Pyongyang from sustaining a nuclear weapons program and maintaining a military that, while weaker than its South Korean counterpart, could still inflict significant damage on the ROK if it chose to do so.

Iran's economy likewise has been out of balance since the 1979 revolution, and its heavy dependence on petroleum revenues that are in decline will no doubt slow down its conventional force modernization. Whether it will truly slow down its nuclear program is quite another matter; previous slowdowns have been due to technical difficulties rather than resource constraints.

Resource constraints also are unlikely to prevent Iran from pursuing its policies of supporting terrorist groups like Hamas and Hezbollah. Indeed, as the financial crisis begins to affect the Middle East, Iran may encourage more unrest among minority Shi'a populations throughout the region, most notably in states like Bahrain, which has a Shi'a majority. Again, any indication of American downsizing of its own defense efforts will simply serve to encourage Iran's destabilizing policies.

Venezuela, like Iran, has an unbalanced, petroleum-driven economy. It too is feeling the pressure of declining oil prices. Like Iran, however, it can be expected to continue, and even intensify its efforts to destabilize states that are friendly to the U.S. and are suffering from the consequences of the world economic meltdown. Hugo Chavez' left-wing populist economic agenda, coupled with his anti-American diatribes, may resonate well with the less well privileged classes in Colombia and elsewhere in Latin America who will suffer most from the effects of the economic crisis and will blame America for it. Chavez already has acolytes in the Presidential palaces of Ecuador and Bolivia. There can be little doubt that he will seek to expand his influence in other Latin American states affected by the crisis, to the detriment of American economic and national security interests.

Threats to Marginally Stable States

The majority of America's most recent military interventions have resulted from instability in states that had failed or were failing: Haiti, Somalia, the Balkans, and to a great extent, Afghanistan, all fall into this category. The economic crisis is likely to exacerbate the political vulnerability of many other states, and lay them open to the kind of destabilizing activities that are practiced by Iran and Venezuela.

Mexico is already in the throes of a major crisis prompted by the increasingly brazen activities of drug lords. The decline in oil prices, coupled with a declining level of oil production, a reduced level of remittances from the United States, and a decline in manufacturing will further weaken the central government's ability to fight the drug lords both directly with its military and police forces, and indirectly through programs that would improve the lives of its people.

Pakistan's internal stability has always been tenuous. For the past few years its growing economic strength provided the government a vehicle with which to counter the rising power of Islamists not only in the Federally Administered Tribal Area, but throughout the country. The economic downturn has already weakened the government's hand vis a vis the Taliban, and will continue to undermine the government's ability to assert its control over the country. Given Pakistan's nuclear arsenal, and its continuing friction with India, which the Islamists continue to fuel, the prospect for a major conflagration in South Asia is very real.

Over the past eight years, the Bush Administration poured considerable resources into Africa; its programs won bipartisan support. America's initial successes in many of the continent's unstable countries are likely to be undermined by the economic crisis. The conflicts in Sudan and Central Africa continue to rage on, while tensions in oil producing states, notably Nigeria, are likely to intensify. One area where American defense spending could have a direct impact on African stability is that of piracy off the Horn of Africa. A stretched United States Navy must have sufficient funds to continue its anti-piracy operations, even as it is called upon for other missions, both long standing deployments, and potential new operations, such as enhancing Israel's missile defense capabilities in the face of a potential Iranian nuclear threat.

International Criminal Activity and the Economic Crisis

An April 2008 report by the Department of Justice highlighted the many ways that international organized crime poses a strategic threat to the United States. These include criminal penetration of global energy and strategic material markets that are vital to American national security interests; logistical and other support to terrorists and foreign intelligence services; weapons smuggling into and out of the United States, often in support of terrorist organizations and corrupting public officials in the U.S. and abroad.

The current international financial crisis is likely to facilitate these and other criminal activities, particularly if declining national budgets in friendly states result in cutbacks in law enforcement capabilities. All too often, criminal activities are viewed in a different compartment from that of national security. Today and while the economic and financial crisis persists, they must be seen as part of a seamless whole that must be addressed in an integrated fashion.

Conclusion

The national security implications of the economic crisis are both broad and profound. They will affect our alliance relationships, our interactions with major

states whose intentions toward us remain unclear, the behavior of unfriendly states, the stability of weak and failing states, and the prospects for fighting international organized crime. Most importantly, the economic crisis could have a major and deleterious impact on our national defense budgets, and therefore, our national security posture, which would complicate, and indeed exacerbate, the relationships we have worldwide. Whether the crisis indeed has such an impact on our defense posture remains very much in the hands of America itself. We can forge ahead with defense modernization. We can protect the jobs of our young engineers and skilled blue collar workers. We can continue to signal our determination to fight for our values and freedoms. The budget is policy. And the policy choice is ours, and ours alone.

Honorable Dov S. Zakheim

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From 2001 to April 2004 he served as the Under Secretary of Defense (Comptroller) and Chief Financial Officer for the Department of Defense, acting as the Secretary of Defense's principal advisor on financial and budgetary matters, developing and managing the world's largest budgets, overseeing all aspects of the Department's accounting and auditing systems, and negotiating five major international defense agreements. From 2002-2004 Dr. Zakheim was DOD's coordinator of civilian programs in Afghanistan. He also helped organize both the June 2003 UN donors' conference on Iraq reconstruction and the October 2003 Madrid Donors' Conference.

From 1987 to 2001 he was both corporate vice president of System Planning Corporation, a technology, and analysis firm based in Arlington, Va. and chief executive officer of its subsidiary, SPC International Corp.. During the 2000 presidential campaign, he served as a senior foreign policy advisor to then-Governor Bush.

From 1985 until March 1987, Dr. Zakheim was Deputy Under Secretary of Defense for Planning and Resources in the Office of the Under Secretary of Defense (Policy), playing an active role in the Department's system acquisition, strategic planning, programming and budget processes. Dr. Zakheim held several other DOD posts from 1981 to 1985. Earlier, he was a principal analyst in the National Security and International Affairs Division of the Congressional Budget Office.

Dr. Zakheim has served on a number of government, corporate, non-profit and charitable boards. His government service includes two terms on the United States Commission for the Preservation of America's Heritage Abroad(1991-93); the Task Force on Defense Reform (1997); the first Board of Visitors of the Department of Defense Overseas Regional Schools (1998); and the Defense Science Board task force on "The Impact of DOD Acquisition Policies on the Health of the Defense Industry" (2000). He currently is Chairman of the National Intelligence Council's International Business Practices Advisory Panel, and a member of the Defense Business Board, which he helped establish, the Commission on Wartime Contracting, the Secretary of the Navy's Advisory Board, the Defense Science Board task force on "Fulfillment of Operational Needs," the Chief of Naval Operations Executive Panel and the Council on Foreign Relations.

A 1970 graduate of Columbia University with a B.A., summa cum laude, Dr. Zakheim also studied at the London School of Economics. He holds a doctorate in economics and politics at St. Antony's College, University of Oxford, where he held three fellowships. Dr. Zakheim is a Senior Advisor at the Center for Strategic and International Studies and was an adjunct Senior Fellow of the Council on Foreign Relations and an adjunct Scholar of the Heritage Foundation. He has been an adjunct professor at the National War

College, Yeshiva University, Columbia University and Trinity College, Hartford, Conn., where he was a Presidential Scholar. The author of a dozen books or monographs, and of numerous articles, Dr Zakheim has lectured and provided print, radio and television commentary on national defense and foreign policy issues domestically and internationally. He is the recipient of numerous awards for his government, professional and civic work, including the Defense Department's highest civilian award in 1986, 1987 and 2004.